

**AUDIT OF  
CONTROL ENVIRONMENT AND OVERALL ACCOUNTING CONTROLS**

Version No. 4.0

August 2004

<b><u>Control Objectives</u></b>	<b><u>Control Activities</u></b>	<b><u>Audit Procedures</u></b>
<b>1. <u>INTEGRITY AND ETHICAL VALUES</u></b>  Management must convey the message that integrity and ethical values cannot be compromised, and employees must receive and understand that message through continuous demonstration of words, actions and commitment to high ethical standards.	Written codes of conduct address ethical business practices, conflicts of interest, and expected standards of ethical and moral behavior including dealings with customers, suppliers, employees and other parties.	<p>a. Evaluate contractor policies, procedures, training and compliance with policies and procedures related to conveying integrity and ethical values. Compliance with DFARS 203.70, Contractor Standards of Conduct, should be considered for DoD contractors.</p> <p>1) Verify the existence of written codes of conduct/ethics. Selectively test the codes of conduct to determine if they adequately cover expected standards of conduct that affect significant internal and external business and employee relationships.</p> <p>2) Verify that the contractor's policies and procedures provide for an ethics training program for all employees. Selectively test this control by evaluating completed training records (DFARS 203.7001(a)(1)).</p> <p>3) Verify that written codes of conduct (i) are periodically communicated to all employees, (ii) are formally acknowledged, and (iii) cite consequences for violations.</p> <p>4) Verify that the contractor performs periodic reviews of company business practices, procedures, and internal controls for compliance with standards of conduct</p>

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		(DFARS 203.7001(a)(2)).
	Management places emphasis on establishing and maintaining an effective system of internal controls and self-governance and does not condone signs of inappropriate practices.	<p>b. Evaluate contractor self-governance activities, as well as the reporting to and cooperation with the Government. Compliance with DFARS 203.70, Contractor Standards of Conduct, should be considered for DoD contractors.</p> <p>1) Verify that the contractor has a system to identify/report noncompliances with codes of conduct and pursue corrective actions. Contractors should have a mechanism, such as a hotline, by which employees may report suspected instances of improper conduct (DFARS 203.7001(a)(3)).</p> <p>2) Determine the extent to which the contractor participates in self-governance programs, such as Coordinated Audit Planning, Defense Industry Initiative, DoD Hotlines, or any procedure for reporting suspected irregularities.</p> <p>3) Reporting to Government Officials. Verify that the contractor's policies and procedures provide for timely reporting to appropriate Government officials of any suspected violation of law in connection with Government contracts or any other irregularities in connection with such contracts (DFARS 203.7001(a)(6)).</p>

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		<p>4) Verify that the contractor's policies and procedures provide for cooperation with any Government agencies responsible for an investigation involving any suspected violation of law. (DFARS 203.7001(a)(7))</p> <p>5) If a DoD contractor does not have an adequate system of management controls implementing the standards of conduct, verify that the contractor has displayed the DoD Hotline Poster prepared by the DoD Office of the Inspector General (DFARS 203.7001(b)).</p>
	Policies and procedures provide guidance on the situations and frequency of management intervention or overrides, approvals and documentation required, and the strict prohibition of manager overrides.	<p>c. Evaluate management intervention and/or overrides.</p> <p>1) Determine whether policies and procedures address the situations and frequency of management intervention, require documentation and approval of intervention, and the strict prohibition of any management overrides.</p> <p>2) If applicable, selectively evaluate documentation of management interventions or overrides. Assess compliance with policies and procedures.</p>
	Internal and external evaluations influence and heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may prompt management to establish specific internal control structure policies or procedures. Management effects prompt correction/disposition of deficiencies noted by	<p>d. Evaluate internal and external audit functions and efforts related to the current accounting system.</p> <p>1) Determine whether the contractor's system of management controls provides for internal and/or external audits, (DFARS</p>

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	auditors on internal controls.	<p>203.7001(a)(4)).</p> <p>2) If the internal or external auditor's work will be relied upon, follow the guidance in CAM 4-1004 to evaluate and document:</p> <ul style="list-style-type: none"> <li>(a) the competency, independence, and objectivity of the internal/external auditor (place a copy of this effort in the permanent file), and</li> <li>(b) the overall quality and applicability (usefulness in reducing the scope of our own evaluation) of the internal/external auditor's work.</li> </ul> <p>If reliance is not to be placed on either of these audit functions, document the reasons why and consider this in your overall assessment of this control objective.</p> <p>3) Determine whether the contractor has an adequate audit plan for conducting internal control and compliance reviews.</p> <p>4) Verify that there are effective follow-up procedures on internal audit recommendations.</p> <p>5) Obtain the external CPA's report of material weaknesses of internal controls and/or management letter for the most recently audited year.</p>

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		<ul style="list-style-type: none"> <li>a) For identified weaknesses of internal control, determine that corrective action has been taken to correct the item.</li> <li>b) Verify that the external CPA does not provide accounting services to the contractor.</li> <li>6) If applicable, review the annual report for SEC registrants for an internal control report. This report includes an assessment of the effectiveness of the internal control structure and procedures for financial reporting and the independent auditor must attest to and report on the contractor's assessment.</li> <li>a) Auditors located at segments or divisions of SEC Registrant companies will need to coordinate this effort with the CAC or Corporate auditors.</li> <li>b) Determine whether corrective action has been taken in response to internal control weaknesses.</li> <li>7) Determine the reason for any recent changes in external auditors. Review the associated SEC filing by predecessor auditors for corroborating evidence.</li> </ul>
		<ul style="list-style-type: none"> <li>e. Identify access to records problems which impact on our ability to assess the internal control structure.</li> </ul>

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		f. Identify potential internal control weaknesses inherent in any Form 2000 or ongoing investigation.
2. <u>BOARD OF DIRECTORS/AUDIT COMMITTEE</u>		
The Board of Directors and the Audit Committee should be sufficiently independent enough from management to constructively challenge management's decisions and act effectively on external audit communications and recommendations. The Board and Audit Committee should take an active role to ensure an appropriate upper management's commitment to ethical business practices and behavior. Auditors at contractor segments should request an assist audit from the corporate auditors to accomplish the audit steps associated with this control objective. If auditors at contractor segments observe indications of possible weaknesses in internal controls that relate to corporate functions, they should refer them to the auditor cognizant of the corporate office. Examples include controls involving the Board of Directors and Corporate Internal Audit.	The Board of Directors and/or Audit Committee are composed of independent members and are actively involved in significant decisions.	<p>a. Obtain a list of Board of Director members. Determine their relationship to the business and assess their independence.</p> <p>b. Evaluate the minutes of the Board of Directors meetings and all communications with the Audit Committee or body of similar authority to determine if the Board is taking an active role in significant management decisions.</p> <p>c. Evaluate the minutes of the Audit Committee meetings to determine if the committee (and/or Board of Directors) is acting effectively on all audit matters, including internal and external audit recommendations.</p>
	The internal audit department is functionally and organizationally independent and is sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions without fear of repercussion.	d. Verify that the internal audit department is functionally and organizationally independent to achieve objectivity in the conduct of its audits.
3. <u>BASIC STRUCTURAL ORGANIZATION</u>		

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The organization structure provides the overall framework for planning, directing and controlling operations.	This structure defines the form and nature of the organization as well as the management functions and reporting relationships.	a. Complete or update the contractor's basic organizational structure questionnaire.
	Authority and areas of responsibility should be appropriately assigned.	b. Evaluate the current organization chart to determine whether it delineates clear lines of authority.
<b><u>4. ASSIGNMENT OF AUTHORITY AND RESPONSIBILITY</u></b>		
Management ensures that appropriate responsibility and delegation of authority is assigned to deal with goals and objectives, operating functions, regulatory requirements, information systems and authorization for changes. The delegation of authority ensures a basis for accountability and control and sets forth individual respective roles.	Written policies and procedures adequately address delegations of authority and clearly delineate duties and responsibilities so that there is an adequate segregation of duties.	a. Verify that policies and procedures exist which specifically state the limitation or delegation of authority.
	Written policies and procedures require evaluation of current financial conditions in order to anticipate and avoid adverse conditions.	b. Verify that there is a clear assignment of responsibility and delegation of authority to deal with such matters as goals, objectives, operating functions and regulatory requirements.
<b><u>5. FINANCIAL CAPABILITY</u></b>		
Management must ensure that the contractor has adequate financial resources to perform on Government contracts.	The contractor conducts periodic assessments of accounts payable and accounts receivable including analysis of accounts payable aging and the collectibility of accounts receivable.	<p>a. Verify that management regularly conducts financial analyses and monitors contract cost performance. Observe that procedures are in place and appropriate management and the board of directors is being informed of adverse conditions.</p> <p>b. Evaluate notes to financial statements, management certifications, and SEC filings (including Management Discussion &amp; Analysis) for any indication of potential adverse financial conditions and discuss these</p>

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		<p>conditions with the controller or other financial managers.</p> <p>c. Consider the impact of any off-balance sheet arrangements disclosed.</p> <p>d. Consider the impact of severe financial distress on the ability of the contractor to perform on Government contracts.</p> <p>e. Determine that policies and procedures require the preparation of an accounts payable aging schedule and that results are elevated to appropriate levels of management.</p> <p>f. Evaluate procedures for analyzing the collectibility of receivables.</p>
	The contractor conducts periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants.	g. Evaluate procedures and verify that the contractor monitors loan covenants and sets up payment schedules.
	The contractor regularly performs short and long term cash flow projections.	h. Verify that the contractor periodically prepares and evaluates cash flow projections.
<b>6. ACCOUNTING SYSTEM AND CONTROLS</b>		
The accounting system is well-designed and is operating effectively to provide reliable accounting data and prevent misstatements that would otherwise occur.	The contractor's accounting system consists of methods and records established to identify, assemble, analyze, classify, record and report an entity's transactions and to maintain accountability for the related assets and liabilities. The system will be designed so that the supporting documentation is complete (i.e., included purpose), accurate (e.g., includes credits where applicable), and readily available for examination.	<p>a. Determine that the contractor maintains a current description of the accounting system, including books of original entry, general and subsidiary ledgers, and any statistical and/or supporting records which demonstrate the initiation of transactions, the flow of documents, and the identification of all points where correcting, adjusting or other cost transfers can be entered into the system.</p> <p>b. Determine if the contractor maintains a chart of accounts which is updated in a timely</p>



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		<p>manner.</p> <p>c. Verify that adequate written policies and procedures exist for approving and documenting, correcting, adjusting, closing, credit and transfer entries.</p> <p>d. Verify that adequate procedures exist for reconciling all subsidiary cost ledgers and cost objectives to the general ledger accounts. If this function is a computerized function, the auditor should document how this is accomplished and selectively test to verify that it is occurring properly.</p> <p>e. Verify that a trial balance is prepared on regular basis and reconciles to the financial statements.</p> <p>f. Verify that adequate procedures exist for controlling monthly accrual calculations and that an adequate approval process is used.</p> <p>g. Verify that there is adequate segregation of duties and responsibilities in such areas as access to accounting records, check-signing authority, recording disbursements in cash journal, and performance of bank reconciliations, etc.</p> <p>h. Determine whether policies and procedures require identification of systemic problems or trends based on error reports. Verify that corrections are processed in a timely manner.</p>
7. <u>COST ALLOCATIONS</u>		

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Management ensures that an item of cost or a group of items of cost are assigned to one or more cost objectives in accordance with rules, regulations, and standards for proper distribution of direct cost and allocation of indirect costs. Management ensures the proper allocation of both the direct assignment of cost and the reassignment of a share from an indirect cost pool.	The contractor maintains a current disclosure statement.	<p>a. Determine that the contractor's disclosure statement is current and adequately describes its accounting practices.</p> <p>b. Document, if applicable, any CAS noncompliances that may impact the internal control structure.</p> <p>c. Verify that adequate written policies and procedures exist for the identification and exclusion of unallowable costs. Determine that the detail and depth of records required as backup support for proposals, billings, or claims are adequate to establish and maintain visibility of identified unallowable costs (CAS 405).</p>
	Written procedures prescribe approvals required in establishing contract charge numbers.	d. Verify that adequate written procedures exist to ensure that charge numbers are based on contractual requirements and are under management control and authorizations.
	Written procedures ensure that the Government receives its share of any income, rebates, refunds, allowances or other miscellaneous credits.	e. Verify that adequate written procedures exist for adjusting costs charged to the Government for any income, rebates, allowances or miscellaneous credits and that appropriate approvals are required.